



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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Interim Executive Director

July 30, 2003

Dear Interested Party:

Staff has reviewed comments received in response to our June 27, 2003, interested parties meeting regarding the proposed amendments to Regulation 1628, *Transportation Charges*. After considering the comments and information provided to date, staff is recommending no changes to Regulation 1628.

Enclosed is the *Second Discussion Paper* on this subject. This document provides the background, a discussion of the issue and explains staff's recommendation in more detail. Also enclosed for your review is a copy of the proposed amendment to Regulation 1628 (Exhibit 1).

A second interested parties meeting is scheduled for **August 7, 2003 at 10:00 a.m. in Room 122** to discuss the proposed amendments to Regulation 1628. If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-4530 before the August 7 meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on August 7, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Todd MacMurray at 916-324-2900 or by e-mail at [todd.macmurray@boe.ca.gov](mailto:todd.macmurray@boe.ca.gov) prior to August 4, 2003. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing.

Any comments you may wish to submit subsequent to the August 7 meeting must be received by **August 25, 2003**. They should be submitted in writing to the above address. After considering all comments, staff will complete a formal issue paper on the proposed amendments to Regulation 1628 for discussion at the **Business Taxes Committee meeting** scheduled for **October 15, 2003**. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the October Business Taxes Committee meeting is welcomed and encouraged. The meeting is scheduled for **9:30 a.m.** in Room 121 at 450 N Street, Sacramento, California.

Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

If you are interested in other topics to be considered by the Business Taxes Committee, you may refer to the "Board Meetings and Committee Information" page on the Board's Internet web site (<http://www.boe.ca.gov/meetings/meetings.htm#two>) for copies of Committee discussion or issue papers, minutes, a procedures manual and calendars arranged according to subject matter and by month.

We look forward to your comments and suggestions. Should you have any questions, please feel free to contact me at (916) 324-1825.

Sincerely,

Charlotte Paliani  
Program Planning Manager  
Sales and Use Tax Department

CP: tdm

Enclosures

cc: (all with enclosures)

Honorable Carole Migden, Chairwoman  
Honorable Claude Parrish, Vice Chairman  
Honorable Bill Leonard, Member, Second District (MIC 78)  
Honorable John Chiang, Member, Fourth District  
Honorable Steve Westly, State Controller, C/O Ms. Marcy Jo Mandel  
Ms. Carole Ruwart, Board Member's Office, First District (MIC 71)  
Ms. Sabina Crocette, Board Member's Office, First District  
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)  
Mr. Romeo Vinzon, Board Member's Office, Third District (via e-mail)  
Mr. Matthew Zylowski, Board Member's Office, Third District  
Ms. Margaret Pennington, Board Member's Office, Second District (via e-mail)  
Mr. Lee Williams, Board Member's Office, Second District (MIC 78 and via e-mail)  
Mr. Tim Treichel, Board Member's Office, Second District (via e-mail)  
Mr. John Thiella, Board Member's Office, Fourth District (MIC 72)  
Mr. Timothy Boyer (MIC 73)  
Acting Chief Counsel (MIC 83)  
Mr. Ramon J. Hirsig (MIC 43)  
Ms. Janice Thurston (MIC 82)  
Mr. Warren Astleford (MIC 82)  
Ms. Sharon Jarvis (MIC 82)  
Mr. Robert Tucker (MIC 82)  
Ms. Jean Ogrod (via e-mail)  
Mr. Jeff Vest (via e-mail)  
Mr. David Levine (MIC 85)  
Mr. Steve Ryan (via e-mail)  
Ms. Jennifer Willis (MIC 70)  
Mr. Dave Hayes (MIC 67)

Mr. Joseph Young (via e-mail)  
Mr. Vic Anderson (MIC 40 and via e-mail)  
Mr. Larry Bergkamp (via e-mail)  
Mr. Geoffrey E. Lyle (MIC 50)  
Ms. Laureen Simpson (MIC 50)  
Mr. Todd MacMurray (MIC 50)  
Ms. Laura Jonoubei (MIC 50)

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## **SECOND DISCUSSION PAPER**

### **Proposed Regulatory Change Regarding Reporting Tax on Delivery and Handling Charges Based on an Alternate Method**

#### **Regulation 1628, *Transportation Charges***

##### **I. Issue**

Should Regulation 1628, *Transportation Charges*, be amended to provide retailers the option to report taxable transportation charges using estimated transportation charges developed from a test projected into the future, rather than reporting the transportation charges on an actual basis?

##### **II. Staff Recommendation**

Make no change to the regulation.

##### **III. Other Alternative Considered**

Ernest J. Dronenburg, Jr. of Deloitte and Touche (Deloitte) submitted a proposal for consideration by staff and discussion at the October 15, 2003, Business Taxes Committee meeting (see Exhibit 1 for a copy of Deloitte's proposal). The proposal seeks to amend Regulation 1628 by adding subdivision (d), which would provide retailers the option to report future transportation charges by third party carriers, such as United States mail, common carriers and contract carriers, using an estimate of the transportation charges developed from a test of the past charges. The proposal would require Board acceptance under Revenue and Taxation Code (RTC) section 6596 of the future reported tax that is based upon estimates, if the proposed methodology is followed. The proposed methodology would:

- Require the retailer to test transportation charges for one current quarter in order to develop a percentage of taxable transportation charges to be used to estimate future transportation charges for the subsequent four quarters;
- Require the evaluation of the future four quarters to determine if there are any "expected material changes" in the future transportation charges base that differ from the facts and circumstances surrounding the test quarter base;
- Require the retailer to perform a "retest" annually;
- Require Board audit staff to annually (if requested by the retailer) review for Board approval the test procedures used and provide RTC section 6596 protection.
- Provide RTC section 6596 protection to future taxable transportation charges estimated either (1) under a Board staff approved test of current charges, or (2) under a retailer

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### Proposed Regulatory Change Regarding Reporting Tax on Delivery and Handling Charges Based on an Alternate Method

#### Regulation 1628, *Transportation Charges*

“retest” that is within a plus or minus 10% variance of the previous year’s test. The RTC section 6596 protection would serve as a basis for relief from additional taxes, penalties, and interest, as provided in RTC section 6596, in the event the estimate overstates the excludable transportation charges and results in additional taxes due. Although the proposal does not specifically state, we assume the Board would provide written advice if the test is approved by Board staff.

#### IV. Background

The Revenue and Taxation Code provides that tax does not apply to “separately stated” charges for the retailer’s cost to transport tangible personal property from the retailer’s place of business, or other point from which shipment is made “directly to the purchaser,” provided the transportation is by other than facilities of the retailer, such as by United States mail, independent contract or common carrier and provided the property is not sold for a “delivered price.” (RTC section 6011(c)(7), 6012(c)(7).) Transportation charges are deemed separately stated only if they are separately set forth in the contract for sale or in a document reflecting that contract, issued contemporaneously with the sale, such as the retailer’s invoice. (Reg. 1628(a).) The retailer may only exclude the actual cost of the transportation. (RTC sections 6011(c)(7), 6012(c)(7); Reg. 1628(b)(2).) To be entitled to the exclusion, the retailer must retain records showing the actual cost of transportation for each transaction. (RTC sections 6011(c)(7), 6012(c)(7); Reg. 1698(b)(1)(B).)

When transportation is by facilities of the retailer or where the property is sold for a delivered price,<sup>1</sup> tax applies to charges for transportation to the purchaser, unless (1) the transportation charges are separately stated, (2) are for transportation from the retailer’s place of business or other point from which shipment is made directly to the purchaser, and (3) the transportation occurs after the sale of the property is made to the purchaser. (*Ibid.*) If transportation is by facilities of the retailer, the retailer may only exclude a reasonable charge for its transportation from the measure of tax. ((RTC sections 6011(c)(7), 6012(c)(7); Reg. 1628(b)(2).)

During an interested parties meeting on June 27, 2003, Mr. Dronenburg of Deloitte explained his proposal to staff and other interested parties and responded to questions and concerns. Subsequently, Deloitte submitted revised text that incorporated responses to some of the questions raised at the meeting.

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<sup>1</sup> Property is sold for a delivered price when the price agreed upon in the contract for sale includes whatever cost or charge may be made for transportation of the property directly to the purchaser. (Reg. 1628(b)(1).)

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#### V. Discussion

##### Deloitte's Proposal

Deloitte argues that it is quite difficult, if not impossible, for retailers to comply with the provisions of Regulation 1628. Deloitte asserts that the timing between when freight is charged to the customer and when delivery actually occurs is a major factor that contributes to the difficulty in complying with the regulation. In a retail setting, Deloitte states, freight is traditionally charged at the time the order is placed, which is generally before delivery occurs. According to Deloitte, at the time they place an order, customers expect to know how much they will pay for freight. Deloitte states that the most efficient means of determining the cost of the freight is looking at past experience, which typically results in a historical average. However, Deloitte contends that the problems associated with using a historical average are that price changes and ancillary charges are not factored into that number. Deloitte suggests that an example of a typical ancillary charge is when the common carrier has to climb multiple floors of a building in order to complete the delivery, since the taxpayer does not always know on which floor of the building the customer is located. Another possible ancillary charge claimed by Deloitte is when the carrier has to make two or three attempts at delivering the product. Factors such as these affect the transportation charge. However, Deloitte asserts that the taxpayer has no way of taking such factors into consideration at the time the order is placed. Deloitte states that in some cases, the amount the customer pays for transportation charges is determined by the customer, and is based solely on the total dollar amount of the customer's purchase.

As Deloitte sees it, taxpayers currently have three options available to deal with transportation charges, each of which Deloitte believes poses problems:

1. Collect tax reimbursement on the entire amount of the separately stated transportation charges;
2. Do not collect tax reimbursement on transportation charges;
3. Perform a real-time calculation of separately stated freight charges and bill each customer the result of the calculation.

Deloitte states that under Option 1, a retailer who collects tax reimbursement on the entire amount of the separately stated transportation charges is at a competitive disadvantage in relation to a retailer who does not charge tax reimbursement on transportation charges. According to Deloitte, such a retailer also runs the risk of having a class action suit filed against him or her under Business and Professions Code sections 17200 and 17204 for the collection of excess tax reimbursement on the excluded portion of the transportation charge.

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Deloitte contends that Option 2 has the disadvantage that on audit the retailer will pay the tax on unreported taxable freight charges plus interest. Over a typical three-year audit period, Deloitte states, tax and interest associated with the charge on freight may be significant. Deloitte further asserts that for financial reporting purposes, retailers are generally required to estimate a potential tax liability and set that amount aside in a reserve account. This is not a desirable accounting outcome, according to Deloitte, especially if the estimate is insufficient to cover the liability.

Option 3, according to Deloitte, is tremendously expensive to implement from an information technology perspective. Deloitte states that the cost of implementing a “real-time cost matrix system” for calculating freight charges far outweighs the benefits achieved. Deloitte adds that even the very best systems are not completely accurate.

The solution to the problems inherent in these three options, as Deloitte sees it, is a new methodology whereby the taxpayer would conduct a test of transactions and calculate a taxable percentage of transportation charges. The resulting percentage would be applied to the total transportation charges to calculate excludable transportation charges to be reported on the sales and use tax return for the four succeeding quarterly reporting periods.

Deloitte believes this method would be appropriate for taxpayers that charge their customers an estimated amount for the cost of freight, but do not make a sales tax reimbursement charge. Furthermore, Deloitte argues this new optional method would not affect the amount of tax due on any transaction nor would it change the documentation requirement for supporting an exclusion from taxable gross receipts. The specific language that Deloitte proposes to add to Regulation 1628 as subdivision (d) reads:

- 1) Develop a taxable percentage from a test of the amounts charged for transportation. This is a transaction by transaction test with no offsets for charges where the retailer’s charge is for less than the actual cost. The amounts charged by the retailer which exceed the actual cost of the transportation to the retailer, being considered taxable, over the total recorded transportation charges for the test period. This test, which would be done annually, must follow a method acceptable to the SBE.
- 2) The succeeding quarterly period bases are then evaluated to determine if there are any expected material changes in the transportation charges base from the facts and circumstances surrounding the base tested. Examples of a material change are; (1) an exceptionally large increase (50%) in the charge made by the common carriers, or (2) an exceptionally large increase (50%) in the charge made by the retailer for freight. In the case of a material change retesting would be required for the succeeding quarters.

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- 3) Then the taxable percentage, as determined in (1) above, is applied against the amount of recorded transportation charges and the product is reported as taxable sales or reduction from excludable transportation charges. The parameters of the population base used to determining the taxable amount to be reported must be consistent with the test population base. The test sample will be drawn from within one quarter's transactions and applied to the following four quarters. After a period of one year a retest must be done. If the results of the test are within a plus or minus 10% variance of the previous number, the amount may be used without the SBE approval.
- 4) The SBE shall verify the methods used and the amounts reported in the normal audit cycle. At the retailer's request the BOE will review the test procedure prior to or at the time the test is undertaken. If the test procedures and supporting documentation are consistent with the BOE audit standards Sec. 6596 protection will be available to the retailer. The protection under Sec. 6596 will apply on test-by-test basis.

The language of the proposal limits this method to sales subject to sales tax, and to third party charges only, i.e., it does not apply to use tax transactions and it does not include charges for transportation by facilities of the retailer.

Subdivision (d)(2) of the proposed language is unclear as to who is responsible for "evaluating the succeeding quarterly period bases to determine if there are any expected material changes in the transportation charges base from the facts and circumstances surrounding the base tested."

Deloitte believes the proposal is a "win/win opportunity" for the state and the taxpayer. According to Deloitte, the state wins because it will get the tax on transportation charges sooner and the state will save time and money in auditing excludable transportation charges. Deloitte states that the taxpayers win because this gives them a reasonable method by which to comply with Regulation 1628, and allows taxpayers to factor in the cost of the self-assessed taxes paid on transportation charges and adjust their selling prices if they so desire. Also, Deloitte states this new methodology will not only be a more equitable method for the taxpayer but also will produce a more accurate answer as to the correct tax due.

#### Proposal Contrary to Law

The Board's Legal Department advises staff that Deloitte's proposal is not authorized by law and would require an amendment to RTC section 6012(c)(7). (See Exhibit 2.) RTC section 6012(c)(7) specifically states that to be excluded from the measure of tax, transportation charges must be "Separately stated... but the exclusion shall not exceed ... the cost to the retailer of transportation by other than facilities of the retailer." Thus, only the actual cost of transportation may be used to calculate the exclusion for transportation charges, since the amount of



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transportation charges excluded from the measure of tax shall not exceed the actual cost of the transportation to the retailer on a transaction by transaction basis. Annotation 557.0690 (4/21/89) confirms this opinion, providing that a retailer cannot use an “average cost of shipping” to calculate an exclusion for transportation charges, and stating, “Only the actual cost of transportation on each order may be excluded from tax under [Revenue and Taxation Code] section[s] 6011(c)(7) and 6012(c)(7).”

A regulation adopted by a state agency is not valid or effective unless it is consistent and not in conflict with the statute. (Gov. Code sec. 11342.2.) Since Deloitte’s proposed amendment to Regulation 1628 would exclude transportation charges from tax based upon something other than the actual cost specified by statute, staff is of the opinion that the proposal is beyond the scope of a regulatory change.

#### Proposed Testing Not Representative

The Board of Equalization’s authority to use sampling in conducting audits is supported by statute and case law. However, the limitation placed upon the Board’s authority to use sampling in an audit is that the test must be representative of the period reviewed, and the findings must be supported by substantial evidence. (See *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 444.)

The Board of Equalization has established guidelines to ensure that audit samples are representative and supported by substantial evidence. For example, the Sales and Use Tax Department’s audit staff is instructed to complete form BOE-472, *Audit Sampling Plan*, with the taxpayer’s input and assistance to document and define the type of test, either statistical or non-statistical, and the parameters for the test, to ensure that the test will be representative of the taxpayer’s typical transactions.

Under Deloitte’s proposal, there is no way to assure that the test of a current quarter is representative as a base for projecting an accurate estimated amount of taxable transportation charges for future quarters. Since the projection of the taxable transportation charges is for a future period, it can never be determined, until after the fact, if the current period used to establish the test base is representative of the future. The statute requires certainty, i.e., the actual cost of transportation, but because the future cannot be predicted with any certainty, the proposed method for reporting tax by using estimates does not comply with the statutory requirement. As Mr. Dronenburg states in his own July 14, 2003, letter to Ms. Charlotte Paliani, “The problems associated with using a historical average are that the price changes and ancillary charges are not factored into that number.”

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##### Proposal Contrary to Current Board Practice

At the June 27, 2003 interested parties meeting, a comparison was made between Deloitte's proposed methodology for reporting transportation charges and the Board audit staff's use of prior audit percentages of error as a means to determine understated taxable measure in a current audit.

Audit Manual Section 0405.33 discusses when it is appropriate to use "prior audit percentages of error" in current audits. Before using a prior audit percentage of error, the Audit Manual requires that the auditor analyze the base to which the percentage is applied to assure no changes to the business have occurred since the prior audit. Such testing should include an examination of source documents for changes in processing procedures since the last audit. Other changes to look for include:

- The nature of the business
- Accounting procedures
- Key personnel changes
- Laws or regulations affecting the business
- Significant increases in the population being sampled

These considerations are used to determine if there have been changes to the business that would make the percentages of error from prior audit periods non-representative for a current audit. However, in Deloitte's proposal it is extremely difficult to determine whether past transactions will be representative of future transactions. Moreover, Deloitte's proposal uses the term "material changes," but provides examples of material changes rather than a definition of the term. The two examples of "material changes" that Deloitte provides in its proposal, (1) an exceptionally large increase (50%) in the charge made by the common carrier and (2) an exceptionally large increase (50%) in the charge made by the retailer for freight, leave a lot of room for taxpayers and staff to disagree on a reasonable definition of "material changes." Furthermore, while Audit Manual Section 0405.33 forbids the use of a prior audit percentage of error in consecutive audits, Deloitte's proposal would permit use of a prior percentage of error in consecutive periods without Board approval if the results of a "retest" are within a plus or minus 10% variance of the previous period.

Current Board practice (pursuant to RTC section 6012(c)(7)) requires proof of actual cost of transportation charges, a bright line test. Deloitte's proposal creates a new area for potential

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disagreement, i.e., what are “material changes” to “the facts and circumstances surrounding the base tested?” The proposal substitutes estimates projected into the future (when all the facts are not yet known) for the current standard of actual costs (facts that are known/available).

Audits are conducted using statistical sampling (the preferred method) and block sampling. Under either method, however, the results of the test are used to come to a conclusion about past transactions, not future transactions. This is because the sample is examined to assure it is representative of the population tested, and the evaluation of the sample is solely related to a specific (known) population. The same rationale does not apply to projections made into the future as Deloitte’s proposal proposes.

#### Currently Available Options to Report Transportation Charges

As stated above, Deloitte notes that taxpayers currently have three options to deal with transportation charges, one of which (“option 2”) is not to collect tax reimbursement on transportation charges.

This option assumes not only that the retailer does not collect tax reimbursement from its customer, but also assumes that once the sale is completed and the actual cost of transportation is known, the retailer fails to properly report and pay the tax. Staff believes that Deloitte has not considered an alternative that is allowed under existing statutes. Under Deloitte’s current proposal, Deloitte limits the use of its method to those transactions, subject to sales tax, upon which the retailer does not collect sales tax reimbursement. The complication, as explained by Deloitte, is that the actual cost of the transportation charge may not be known, and therefore the total tax liability may not be known at the time of sale. However, it is staff’s understanding that the transportation charge is known at the time of shipment. Once that amount is determined, a retailer may compute the actual transportation charge excluded from tax and therefore report and pay the actual tax liability. This option would avoid the concerns that are raised in Deloitte’s options one, two, and three since it would not be in violation of consumer protection law suits, would not result in the incurring of interest charges, and does not require a “real-time cost matrix system” to calculate transportation costs. This option would not require a test, an estimate, or a projection of any kind since it would use the actual costs of transportation to determine the amount subject to tax. Furthermore, it ensures that the proper amount of tax, no more or no less, is reported and paid by the retailer.

#### Workload Issues

The proposal will require additional Board auditor time spent verifying and approving the taxpayer’s test when requested to do so by a taxpayer. Under normal circumstances, taxpayers

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are eligible for audit every three years. Under Deloitte's proposal, Board audit staff would be required (if requested by the taxpayer) to conduct a "mini-audit" every year. This "mini-audit" would (in addition to verification of the transportation charges) require auditors to examine sales that are claimed exempt or excluded from the measure of tax, because if a sale is not subject to tax, the transportation charges for the tangible personal property sold are not subject to tax either, whether or not they are separately stated or reflect the actual cost of transportation. For example, to verify that the transportation charge on a claimed sale for resale was not taxable, the auditor would have to review a resale certificate. If the resale certificate was not available, or not in proper form, the auditor could either (1) assume the sale was taxable or (2) try to verify that the sale was in fact an exempt sale for resale, perhaps by contacting the customer. This would be a very time consuming process. During this time of anticipated current and future budget cutbacks, this could cause substantial staffing problems.

The Board is working with taxpayers that have applied for the Alternative Method for Reporting Use Tax Purchases (AMRUT). Currently, there is a considerable amount of time between when the taxpayer applies to the program and when his or her proposed reporting method is approved. This is due to the fact that both taxpayers and Board staff must expend substantial resources in order to meet the program requirements. A similar time lag could be expected for requests for approval of alternate reporting methods for transportation costs. This would be problematic because there would be no RTC section 6596 protection if the retailer were using the taxable percentage to report before staff has had a chance to audit the calculations.

#### Local and District Tax Issues

The proposed language does not address local and district tax reporting issues. The proposed reporting method contains no provision for ensuring that local tax is correctly allocated and that any applicable district taxes are correctly calculated and paid to the proper district.

#### Software Available to Calculate Freight Charges

Deloitte has argued that it is difficult and time consuming to bill customers based on actual freight charges. However, the United Parcel Service (UPS) website offers free software for calculating such charges. In addition, the UPS website has various weight/distance tables that can be used to calculate freight charges in advance. Other software programs also apparently are available to immediately calculate actual transportation charges.

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##### Comments Made at Interested Parties Meeting

At the June 27, 2003 interested party meeting, an interested party asked if the proposed method could allow an unscrupulous taxpayer to “game the system.” The answer is yes. For example, a dishonest taxpayer could calculate the percentage of taxable transportation charge and have the calculation approved by staff. This would be done in the first quarter. Then, starting in the second quarter, the dishonest taxpayer could simply increase the amount charged to its customers for shipping by, say, 49% (just under the 50% threshold for a “material change”). For the next four quarters the taxpayer would use the Board approved taxable percentage but would be applying it to a 49% larger base. This would result in the taxpayer being able to exclude from tax a larger portion of its gross receipts.

##### RTC Section 6596 Relief

On the whole, the proposal would not be in the State’s best interests in that the State would be required to offer the retailer relief against additional tax, interest, and penalties. Alternatively, if the computed percentage understates the true tax liability, there is no means to collect the tax that is actually due. For example, if use of the percentage produced by the test happens to understate the retailer’s true liability, the Board could not recover this liability from the retailer if the retailer had been provided relief under RTC section 6596. However, if the percentage used happens to overstate the retailer’s liability, the retailer could simply file a claim for refund and recover any such overpayments of tax.

Furthermore, Deloitte’s proposal states, “After a period of one year a retest must be done. If the results of the test are within a plus or minus 10% variance of the previous number, the amount may be used without the BOE approval.” Based on conversations with Mr. Dronenburg, staff understands it is the intention of Deloitte that RTC section 6596 relief would continue under these circumstances. Consequently, if the Board did not audit the retailer within three years, this variance could grow considerably without the Board’s knowledge and thereby result in uncollected sales tax.

## **VI. Summary**

Deloitte proposes to amend Regulation 1628 to allow retailers the option of reporting transportation charges based on the results of a test. This would make it easier for retailers to report their transportation charges. Deloitte states that under the current regulation, retailers face three options for reporting such charges, none of which are favorable. Deloitte believes the new methodology would not affect the amount of tax due on any transaction and that it would be a win/win opportunity for both the State and the taxpayer.

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Staff believes that the proposal is not authorized by statute and would require an amendment to RTC section 6012 or other change to existing law. In addition, the proposal is contrary to current Board practices. Furthermore, the proposal would require substantial audit time and would place an extraordinary burden upon staff in a time of anticipated budget cuts. Finally, the proposal would create a one-sided arrangement in which the taxpayer has nothing to lose and everything to gain, while the reverse may apply to the State.

Staff welcomes suggestions from parties affected by these proposed revisions to Regulation 1628.

Prepared by the Program Planning Division, Sales and Use Tax Department

Current as of 07/29/03

Second Discussion.doc rev. 7-8-02

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## **Regulation 1628. Transportation Charges.**

Reference: Sections 6010.5, 6011, 6012, Revenue and Taxation Code.

**(a) Transportation by Carrier.** Except as provided in paragraph (c) below, in the case of a sale, whether by lease or otherwise, tax does not apply to "separately stated" charges for transportation of property from the retailer's place of business or other point from which shipment is made "directly to the purchaser," provided the transportation is by other than facilities of the retailer, i.e., by United States mail, independent contract or common carrier. The place where the sale occurs, i.e., title passes to the customer or the lease begins, is immaterial, except when the property is sold for a delivered price or the transportation is by facilities of the retailer, as explained in (b) below. The amount of transportation charges excluded from the measure of tax shall not exceed the cost of the transportation to the retailer.

Transportation charges will be regarded as "separately stated" only if they are separately set forth in the contract for sale or in a document reflecting that contract, issued contemporaneously with the sale, such as the retailer's invoice. The fact that the transportation charges can be computed from the information contained on the face of the invoice or other document will not suffice as a separate statement. If a separately stated charge is made designated "postage and handling" or "shipping and handling", only that portion of the charge which represents actual postage or actual shipment may be excluded from the measure of tax. Such amounts may be excluded from the measure of tax even though such amounts are not affixed to, or noted on, the package. A separately stated charge designated "handling" or "handling charge" is not a separate statement of transportation charges. Tax applies to such charges, notwithstanding the fact that postage or shipment charges may or may not be affixed to or noted on the package.

Property will not be considered delivered "directly to the purchaser" if it is shipped to the retailer, to the retailer's agent or representative, or to anyone else acting in the retailer's behalf. Any separately stated charges by the retailer for the transportation of property to, rather than from, the retailer's place of business, or to another point from which the property will then be "delivered directly to the purchaser," are included in the measure of tax. Such charges represent incoming freight and are taxable as part of the cost of the property sold by the retailer.

### **(b) Transportation by Retailer's Facilities or Property Sold for Delivered Price.**

(1) Definition. "Delivered Price." Property is sold for a delivered price when the price agreed upon in the contract for sale includes whatever cost or charge may be made for transportation of the property directly to the purchaser. A sale for a "guaranteed price" including a separately stated amount for transportation is a sale for a "delivered price." Property is not sold for a delivered price when the price is agreed upon and to this price is added a separately stated amount representing the cost or charge for transportation of the property directly to the purchaser and any increase or decrease in the actual cost of transportation is borne by or credited to the purchaser.

(2) In General. Except as provided in paragraph (c) below, when transportation is by facilities of the retailer or the property is sold for a delivered price, tax applies to charges for transportation to the purchaser, unless (A) the transportation charges are separately stated, (B) are for transportation from the retailer's place of business or other point from which shipment is made directly to the purchaser, and (C) the transportation occurs after the sale of the property is made to the purchaser. When the sale occurs before the transportation to the purchaser commences, the tax does not apply to separately stated charges for the transportation. The amount that may be excluded from the measure of the tax cannot exceed a reasonable charge for transportation by facilities of the retailer or the cost of transportation by other than facilities of the retailer.

#### **(3) Determination of When Sale Occurs.**

(A) Security Agreements. When a sale is made pursuant to a security agreement in which the retailer retains the title as security for the payment of the price, the sale occurs when possession of the property is transferred by the retailer to the purchaser or other person at the purchaser's direction.

(B) Leases. When the sale is by lease, the sale occurs upon the transfer of possession or granting of the right of possession of the property by the lessor to the lessee or other person at his direction.

(C) Sale on Approval. When the sale is on approval, the sale does not occur until the purchaser accepts the property.

(D) Other Sales. Unless explicitly agreed that title is to pass at a prior time, the sale occurs at the time and place at which the retailer completes his performance with reference to the physical delivery of the property, even though a document of title is to be delivered at a different time or place. If the contract requires or authorizes the retailer to send the property to the purchaser but does not require him to deliver it at destination, the retailer completes his performance with reference to the physical delivery of the property at the time and place of shipment, e.g., delivery of the property to a carrier for delivery by the carrier to the purchaser; but if the contract expressly requires delivery at destination, including cases where one of the terms of the contract is F.O.B. place of destination, the retailer completes his performance with reference to the physical delivery of the property on tender to the purchaser there. When delivery of the property is by facilities of the retailer, title passes when the property is delivered to the purchaser at the destination unless there is an explicit written agreement executed prior to the delivery that title is to pass at some other time.

(4) Place of Sale. For the purposes of the State Sales and Use Tax Law (but not for the purposes of the Bradley-Burns Uniform Local Sales and Use Tax Law nor for the purposes of the Transactions and Use Tax Law) the place of the sale or purchase of tangible personal property is the place where the property is physically located at the time the act constituting the sale or purchase takes place.

**(c) Transportation of Landfill Material.** Operative January 1, 1989, tax does not apply to separately stated charges for transportation of landfill material, e.g., sand, dirt or gravel, removed from the ground and transported from the excavation site to a landfill site specified by the purchaser if:

(1) the amount of transportation charges excluded from the measure of tax does not exceed a reasonable charge for transportation by facilities of the retailer or the cost of the transportation by other than facilities of the retailer, or

(2) the consideration received is solely for the purpose of transporting the material to a specified site and the material is transferred without charge. If such transportation charges are in excess of a reasonable charge for transportation by facilities of the retailer or in excess of the cost of the transportation by other than facilities of the retailer, the provisions of this paragraph will not apply.

For purposes of this paragraph, it is immaterial when title passes to the purchaser of the landfill material.

**(d) Testing Method for Reporting Taxable Transportation Charges.**

If the retailer does not charge tax reimbursement and if transportation charges would qualify to be excludable under (a) above, except that the amount separately stated is an estimate by the retailer, at the retailer's expense they may report on a taxable percentage basis if they follow the formula:

- 1) Develop a taxable percentage from a test of the amounts charged for transportation. This is a transaction by transaction test with no offsets for charges where the retailer's charge is for less than the actual cost. The amounts charged by the retailer which exceed the actual cost of the transportation to the retailer, being considered taxable, over the total recorded transportation charges for the test period. This test, which would be done annually, must follow a method acceptable to the BOE.
- 2) The succeeding quarterly period bases are then evaluated to determine if there are any expected material changes in the transportation charges base from the facts and circumstances surrounding the base tested. Two examples of a material change are: (1) an exceptionally large increase (50%) in the charge made by the common carriers or (2) an exceptionally large increase (50%) in the charge made by the retailer for freight. In the case of a material change retesting would be required for the succeeding quarters.
- 3) Then the taxable percentage, as determined in (1) above, is applied against the amount of recorded transportation charges and the product is reported as taxable sales or reduction from excludable transportation charges. The parameters of the population base used to determine the taxable amount to be reported must be consistent with the test population base. The test sample will be drawn from within one quarter's transactions and applied to the following four quarters. After a period of one year a retest must be done. If the results of the re-test are within a plus or minus 10% variance of the previous number, the amount may be used without the BOE approval.
- 4) The BOE shall verify the methods used and the amounts reported in the normal audit cycle. At the retailer's request the BOE will review the test procedure prior to or at the time the test is undertaken. If the test



procedures and supporting documentation are consistent with the BOE audit standards. Sec. 6596 protection will be available to the retailer. The protection under Sec. 6596 will apply on test-by-test basis.

## APPENDIX

### (a) Examples of Contract for Delivered Price.

- (1) The contract for sale provides for the sale of property for \$100 per unit delivered to the purchaser.
- (2) The contract for sale provides for the sale of property for \$100 per unit "which includes cost of delivery at \$10 per unit."
- (3) The contract for sale provides for the sale of property for \$100 per unit delivered, freight prepaid.
- (4) The contract for sale provides for the sale of property for \$100 per unit freight collect and allowed.
- (5) The contract for sale calls for the sale of property for a guaranteed price of \$100 consisting of \$90 plus \$10 freight.

### (b) Examples of Contracts Which Are Not for a Delivered Price.

- (1) The contract for sale provides for the sale of property for \$100 per unit freight collect.
- (2) The contract for sale provides for the sale of property for \$100 per unit actual freight prepaid and added to the sales price.

**(c) Examples of Application of Tax.** All deliveries are by independent carrier. All billings are in accordance with the terms of the contract.

- (1) The contract for sale provides for the sale of property for \$100 per unit delivered to the purchaser with freight prepaid.

Tax applies to sales price of \$100 per unit with no deduction for freight charge since the freight charges are not separately stated. The contract is for a delivered price and requires delivery to the purchaser. Title does not pass to the purchaser prior to delivery.

- (2) Contract for sale provides for the sale of property for \$100 per unit. The retailer is required to ship the property to the purchaser freight collect.

Tax applies to \$100 per unit since the responsibility for the payment of the freight is upon the purchaser, and the seller makes no charge for freight. Since the carrier will bill the purchaser for the actual freight charge, there will be a separate statement of the freight. The property is not sold for a delivered price.

- (3) The contract for sale provides for the sale of property for \$100 per unit freight collect and allowed. The measure of tax is \$100 per unit less the amount of the freight paid to the carrier and shown on the payment voucher sent to the retailer by the purchaser.

The sale is for a delivered price. Separately stated transportation charges are excludable from the measure of tax since the transportation occurred after the sale of the property. If the contract for sale explicitly provided for passage of title upon delivery to the destination, then the measure of tax would be \$100 per unit since the sale was for a delivered price and title did not pass prior to transportation.

- (4) The contract for sale provides for the sale of property for \$100 per unit plus actual freight of \$10 per unit. Any increase or decrease in the freight is for the account of the buyer.

Tax applies to \$100 per unit since the contract is not for a delivered price and shipment is by independent carrier.

- (5) The contract for sale provides for the sale of property for \$100 plus freight of \$10, and the seller guarantees the price will not exceed \$110.

Tax applies to \$100 because the sale is for a delivered price and there is no showing that title was to pass upon delivery at the destination. A contract will be construed as a shipment contract unless it expressly requires delivery at destination point. If the contract for sale explicitly provided for passage of title upon delivery to the destination, then

the measure of tax would be \$110 since the sale was for a delivered price and title did not pass prior to transportation.

(6) The contract for sale provides for the sale of property for \$100 per unit freight equalized with x city. The invoice shows 10 units at \$100 per unit, \$1,000, freight from x city \$100, total \$1,100.

Under these circumstances, tax applies to \$1,000 since the only separate statement of freight is the freight equalized with x city in the amount of \$100. If the actual freight paid to the carrier for the transportation of the property from the retailer's place of business or other point from which shipment is made directly to the purchaser is less than \$100, the exclusion will be limited to the amount paid to the carrier.

(7) Assuming the same facts as above, except the invoice shows 10 units at \$100 per unit, \$1,000, freight equalized with x city \$100, total \$1,100. The invoice also shows the notation, "Actual freight prepaid from point of shipment to destination is \$200."

The sale is not for a delivered price. On the basis of the above billing, a separate statement of freight is made in the amount of \$200. Accordingly, the measure of tax is \$1,100 minus \$200, or \$900.

History: Adopted June 20, 1962, effective July 3, 1962.

Amended August 8, 1962.

Amended September 2, 1965.

Amended by renumbering November 3, 1971, effective December 3, 1971.

Amended November 11, 1971, effective December 16, 1971.

Amended October 11, 1984, effective December 13, 1984. In (a) deleted former second sentence and added last paragraph. Completely revised (b) (3) (D) and examples (c) (3) and (c) (5).

Amended April 5, 1989, effective June 21, 1989. Amended to provide that a charge for the transportation of landfill from an excavation site to a site specified by the purchaser of the landfill is exempt from the tax if the charge is separately stated and does not exceed a reasonable charge or if the entire consideration consists of payment for transportation.

Amended February 8, 1995, effective July 19, 1995. Amended subdivision (a) to reflect that where a separately stated charge is designated "postage and handling" or "shipping and handling," the exact amount of postage or shipping charges need not be affixed to the package but that such a charge marked "handling" is not a separate statement of transportation charges. Amended subdivisions (b)(2) & (3) to correct cross references in the California Code of Regulations.

Revenue and Taxation Code Section

6012(c) ``Gross receipts`` do not include any of the following:

- ...
- (7) Separately stated charges for transportation from the retailer's place of business or other point from which shipment is made directly to the purchaser, but the exclusion shall not exceed a reasonable charge for transportation by facilities of the retailer or the cost to the retailer of transportation by other than facilities of the retailer. However, if the transportation is by facilities of the retailer, or the property is sold for a delivered price, this exclusion shall be applicable solely with respect to transportation which occurs after the sale of the property is made to the purchaser.

...